JOINT ECONOMIC COMMITTEE
CHAIRMAN ERIK PAULSEN (R-MN)

August 2, 2018

August FOMC Review

FOMC Review Snapshot
- The Fed kept its key policy rate, the interest on excess reserves (IOER) rate, at 1.95% as expected.
- The fed funds target range also remained unchanged at 1.75-2.00%.
- The inflation rate has finally moved near the Fed's 2 percent target after 5 years of undershooting it.
- As the economy continues to strengthen, the Fed will likely raise the IOER rate twice more this year.

Details

Following the Federal Open Market Committee (FOMC) meeting's conclusion Wednesday**, the Fed left the interest on excess reserves (IOER) rate unchanged at 1.95%.** The fed funds rate range remains at 1.75-2.00%. The IOER rate once was set equal to the top of the fed funds rate range, but the FOMC made a "small technical adjustment" following its previous meeting so that the IOER rate would be 5 basis points below the upper bound of the target range. Nonetheless, this has no practical relevance as banks continue to hold large excess reserves at the Fed and have no need to borrow in the fed funds market (see Box 2). The IOER rate largely influences how much of their excess reserves they are inclined to lend. Hence, the **key monetary policy interest rate continues to be the administratively determined IOER rate, not the fed funds rate.**

Since October 2017, the Fed has continued to wind down its balance sheet, which as represented by the monetary base shown in Fig. 1, is shrinking slowly as planned.

The inflation rate has finally moved closer to the Fed's symmetric 2% inflation target (Fig. 2)**,** as measured by the core personal consumption expenditures (PCE) price index. (Two percent is not a ceiling but an average to be achieved over time.) Most FOMC members expect some modest overshoot, which would make up for some of the five years of consistent undershooting. Market-based measures suggest inflation is expected to undershoot the Fed's target over the next 10 years.[1] The fed funds futures market anticipates two more Fed interest rate hikes this year, as does the FOMC based on projections issued at is last meeting (see JEC's previous FOMC Review).

Context

Following Q2-2018 real GDP growth of 4.1% and inflation registering 1.9% (core PCE price index), the economy is in a "Goldilocks" state. At his previous post-FOMC meeting press conference, Fed chairman Jay Powell noted "the economy is doing very well" and that "business investment continues to grow strongly." This development, arising from regulatory and tax reform, has enabled the Fed to gradually increase the IOER rate.

Fig. 1 Monetary Policy Instruments

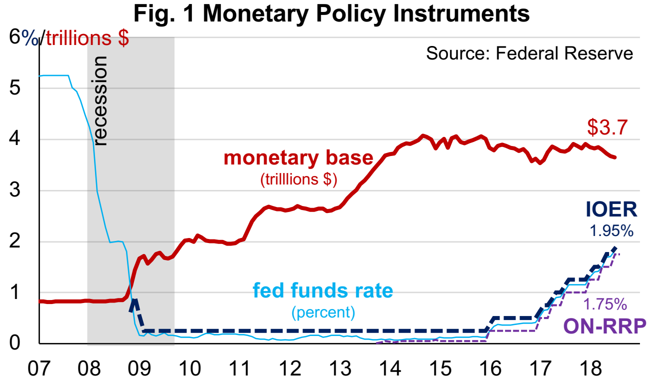


Fig. 2 Price Stability Indicators

year-over-year percentage changes

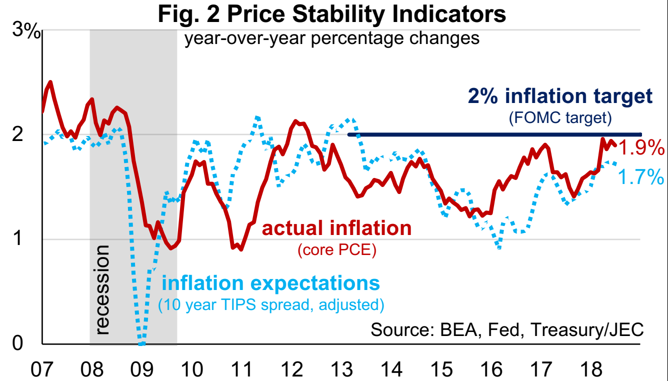
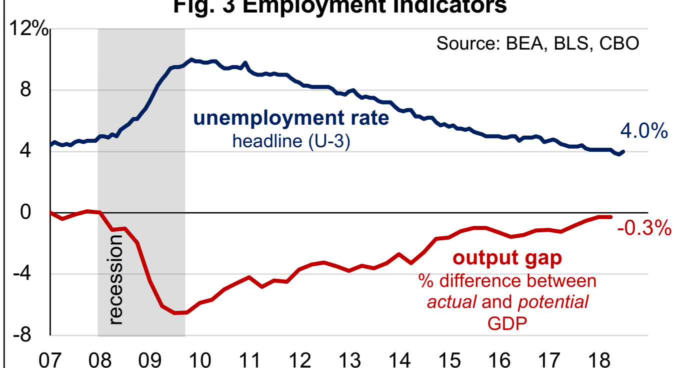


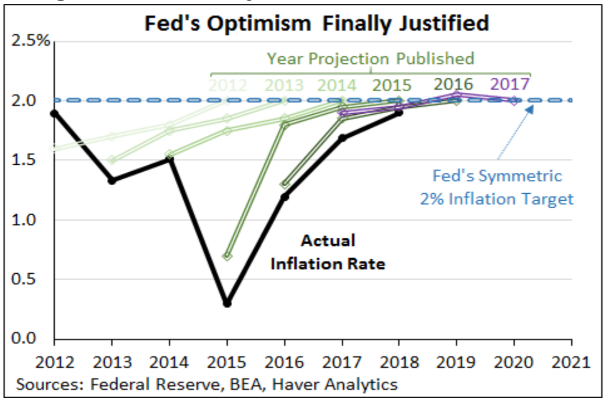
Fig. 3 Employment Indicators



Noteworthy

Monetary policy is easy or tight depending on where the Fed's policy rate (currently the IOER rate) is set relative to the "natural rate of interest, r*," which is not directly observable. Supply and demand for loanable funds, mostly determined by saving and investment, respectively, determine r*. A higher r* relative to a given IOER rate encourages banks to use a greater proportion of their abundant excess reserves for credit, which stimulates aggregate demand.

Figure 4. Fed's Projections and Actual Inflation



For most of the Obama Administration, business confidence was extremely low, suggesting a low r* relative to the Fed's IOER rate, leading to sluggish aggregate demand growth and below target inflation. Since the November 2016 election, business confidence has surged, portending an increased demand for loanable funds and a higher r* relative to the IOER rate thus effectively easing monetary conditions. As Figure 4 shows, this has modestly increased inflation and allowed the Fed to raise the IOER rate further above the dreaded zero lower bound (ZLB), which limits the Fed's ability to stimulate the economy by cutting short-term interest rates.

Box 1: The Federal Open Market Committee (FOMC)

The FOMC typically meets eight times per year. It consists of the seven governors from the Fed's Board of Governors in D.C. (with four current vacancies), and 12 regional Fed bank presidents.

While all Fed governors have a vote on the FOMC, only five Fed bank presidents can vote. The New York Fed president is a permanent voting member, and four others can vote on an annually rotating basis.

Box 2: IOER and ON-RRP

In 2008, the administratively determined interest on excess reserves (IOER) became the Fed's key policy interest rate, supplanting a market-determined federal funds rate, which the Fed would influence by making small interventions in the fed funds market. The Fed pays IOER on funds banks keep on deposit (i.e., excess reserves) with the Fed that might otherwise have been lent to consumers or businesses. All else equal, a higher IOER rate portends a tighter monetary policy, because it encourages banks to hold reserves rather than make more loans, which tends to slow inflation.

A much-reduced level of trading still occurs in the federal funds market because GSEs (government-sponsored enterprises like Fannie Mae and Freddie Mac) are ineligible to earn IOER. GSEs lend their idle cash to banks at the fed funds rate, which banks deposit to earn a higher IOER rate. To prop up the fed funds rate as the Fed raises the IOER rate, the Fed withdraws cash from the market by temporarily selling some of its securities for cash at its overnight-reverse repurchase (ON-RRP) rate, which sets a floor on the fed funds rate.

The continued existence of the federal funds market and the ON-RRP facility should not distract from the fact that the IOER rate is currently the key monetary policy interest rate.

[1] The 10-year "TIPS spread" measures expected inflation by taking the difference between the market yields on 10-year U.S. Treasury notes and 10-year Treasury Inflation Protected Securities. "TIPS" compensate holders for changes in money's purchasing power as measured by the consumer price index, CPI. Historical data and the Congressional Budget Office (CBO)'s average projections of 2.4% CPI inflation and 2.0% personal consumption expenditures (PCE) inflation over the next 10 years indicate that CPI overstates inflation by 0.4 percentage point on average. JEC adjusted the TIPS spread by subtracting 0.4 percentage point to make the measures comparable to the Fed's preferred inflation indicator (PCE).